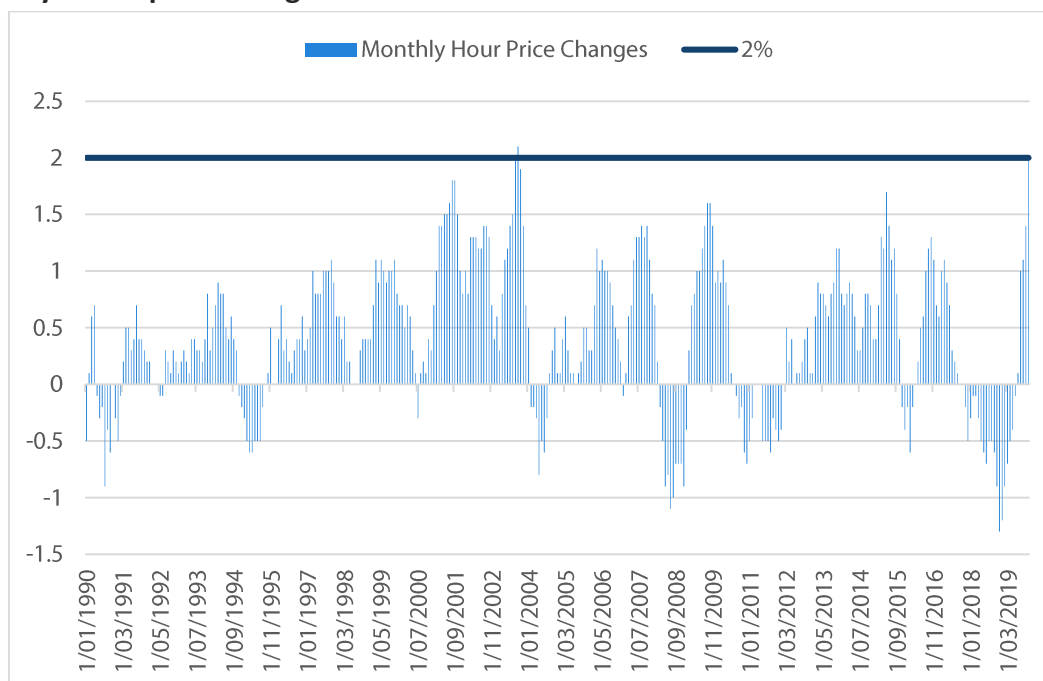


# What happens if house prices go into orbit?

December | Chris Rands, Portfolio Manager, Fixed Income, Nikko Asset Management

Over the past three months the run of strong Australian house prices has continued, posting a 2% increase for the month of October. This historically high level of appreciation has only been seen a handful of times over the past 30 years; the last time being 2003. This raises two important questions: how far should we expect prices to rise and how willing is the Reserve Bank of Australia (RBA) to push them higher?

Chart 1 Monthly house price changes



Source: Bloomberg

## House Prices – What to Expect

Recent research from the RBA describes the effect that changing interest rates can have on housing. This is achieved by comparing the cost of renting a dwelling versus the cost of ownership (where costs of ownership includes the sum of interest payments, repairs, rates and other running costs, less expected capital appreciation).

“At a user cost of 6 per cent we estimate that a sustained percentage point drop in interest rates would, in the long run, boost housing prices by 17 per cent...

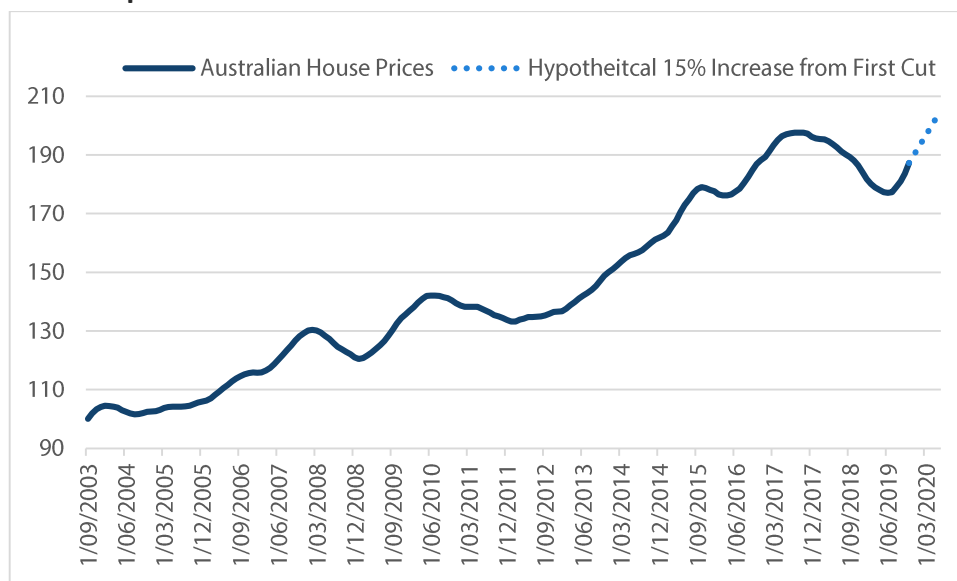
With a user cost of 3 ½ per cent... a percentage point drop in the expected real mortgage rate would boost housing prices by 28 per cent in the long run.”

—A Model of the Australian Housing Market – Reserve Bank of Australia

Given the RBA has already reduced interest rates by 0.75% this year, we can get a feel for just how far prices could rise. If we assume that average user costs are between 3 - 6%, then barring no changes in rents, we should expect price rises of approximately 15 – 20%. This would be in line with the results seen in both 2015 and 2016, as prices appreciated by approximately 8 – 12% following the 50 basis points of cuts in each year.

Assuming an increase in house prices from the first RBA cut, Chart 2 shows that a 15% appreciation would see house prices setting new all-time highs in mid-2020.

**Chart 2 Australian house price index**



Source: Bloomberg, Nikko AM

If this happens, we should begin to question how far will the RBA be willing to reduce interest rates in the face of house prices reaching all-time highs? While the RBA has been missing their inflation targets, they are also responsible for financial stability and need to be aware of the impact of their decisions on asset prices.

“In fulfilling its mandate to promote financial system stability, the Reserve Bank has a role both in mitigating the risk of financial disturbances with potentially systemic consequences”

—Role of the Reserve Bank In Maintaining Financial Stability – Reserve Bank of Australia

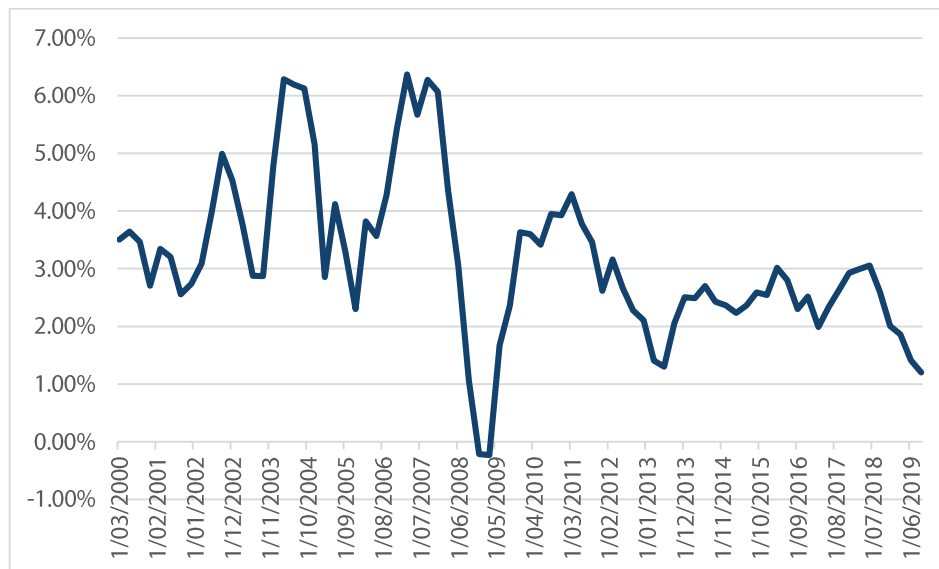
In late 2017, market commentators consistently talked about the financial stability concerns of high house prices and the media often referred to housing affordability due to rising prices. If 0.75% of interest rate cuts is enough to get house prices up over 10% next year, then adding another two cuts to take the cash rate to 0.25% and starting quantitative easing (QE) could send house prices to stratospheric levels.

Unless the RBA truly believes the economy is on a downward trajectory, which doesn't seem to be the base case given Governor Lowe keeps referring to a “gentle turning point”, then it stands to reason that they should wait to see how this change in housing outlook flows into the economy.

### GDP - When's Consumption Coming Back?

On the back of this it is important to ask the question of whether this improved housing outlook will flow into the real economy. Part of the reason the RBA is concerned about the economic outlook is that household consumption has been slowing, growing at barely 1% p.a.

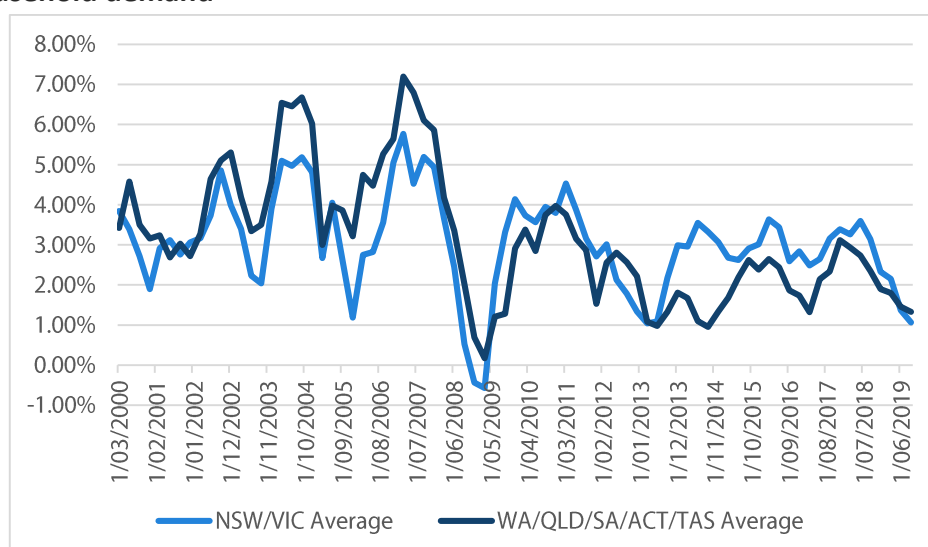
**Chart 3 Australian GDP — Household consumption**



Source: Bloomberg

The breakdown of household demand by state shows that the stable base of 3% p.a. growth in the nation's two biggest states (NSW and Victoria) has now fallen to be only 1% p.a. Given Melbourne and Sydney property prices saw the largest declines nationally, it should not be surprising that there was a considerable step down in household demand. Without tailwinds from the housing sector it is hard to envisage consumption running consistently at 3% p.a., as this is well ahead of what households have been receiving in wage gains – averaging a little over 2% for the past four years.

**Chart 4 State household demand**



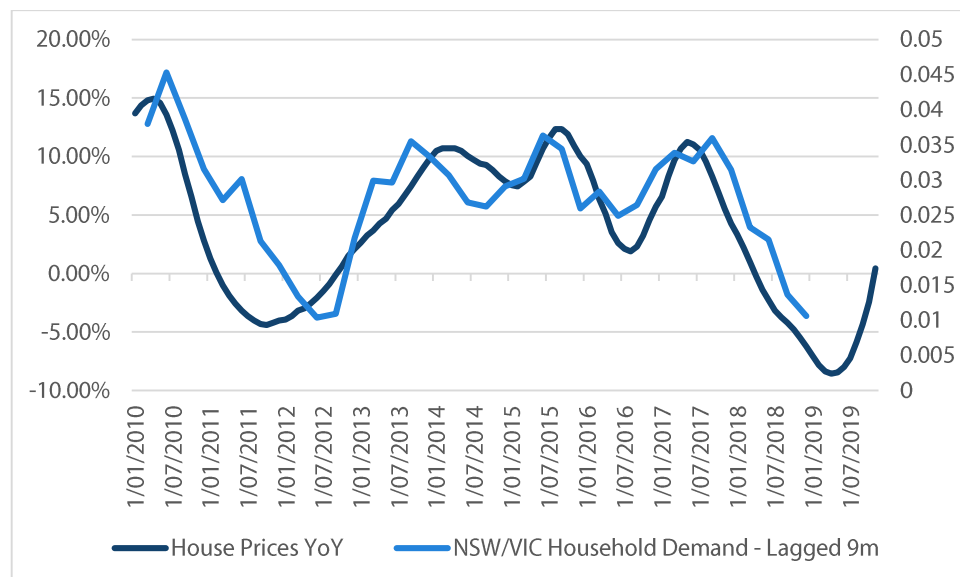
Source: Bloomberg, Nikko AM

State demand for NSW and Victoria shows a strong correlation with house prices. Since 2010, the direction of house prices has been a strong leading indicator for household consumption in these states.

Chart 5 shows household consumption in NSW and Victoria lagged by nine months compared to nationwide house price changes. This shows that the pull lower in consumption is partly due to the poor housing outcomes of late 2018 and early 2019, which at this time last year was not thought not to be flowing into consumption. However, given the lag of nine months, we can see that households had a delayed response to the price changes which subsequently led to the poor outcomes that have more recently been seen.

Looking forward, this implies that we should see continued weakness in these consumption figures through the end of this year - before picking up with the more optimistic house price outlook of 2020.

**Chart 5 NSW and Victorian household demand**



Source: Bloomberg, Nikko AM

The challenge for the RBA running monetary policy is that the flow-on effects from their policy actions take time to hit the real economy.

The RBA alluded to the above in their December interest rate decision:

“The main domestic uncertainty continues to be the outlook for consumption, with the sustained period of only modest increases in household disposable income continuing to weigh on consumer spending...

Given these effects of lower interest rates and the long and variable lags in the transmission of monetary policy, the Board decided to hold the cash rate steady at this meeting while it continues to monitor developments, including in the labour market.”

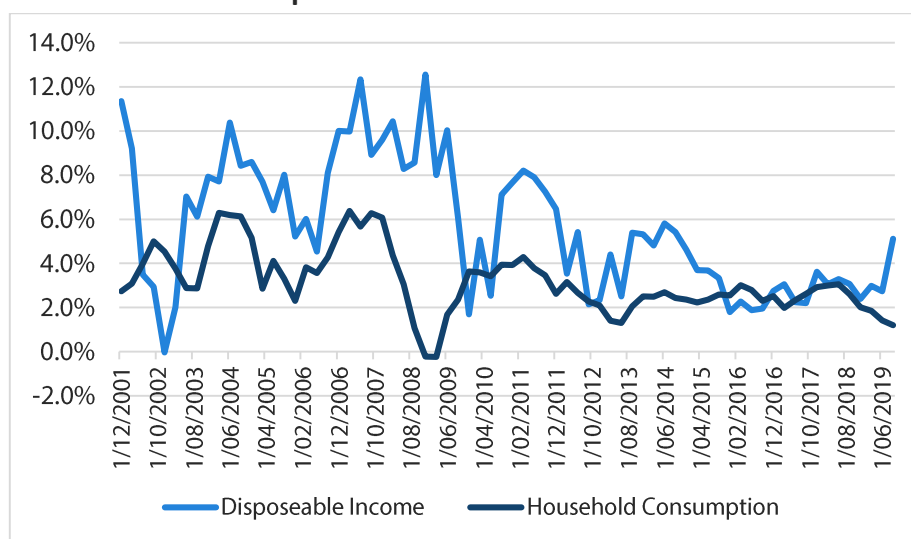
Source: Monetary Policy Decision- December 2019 – Reserve Bank of Australia

As shown in Chart 5, over the past 10 years this long and variable lag seems to be about nine months for household consumption. If 2012/2013 is our guide for demand, then we should start to see an improvement early next year.

### Households – So Far Saving Their Gains

The most recent GDP results also showed that disposable income increased 5.1% over the year, the largest increase since 2014, due to recent tax cuts implemented by the government. Unfortunately for the RBA this didn't bring with it an increase in spending.

**Chart 6 Disposable income and consumption**



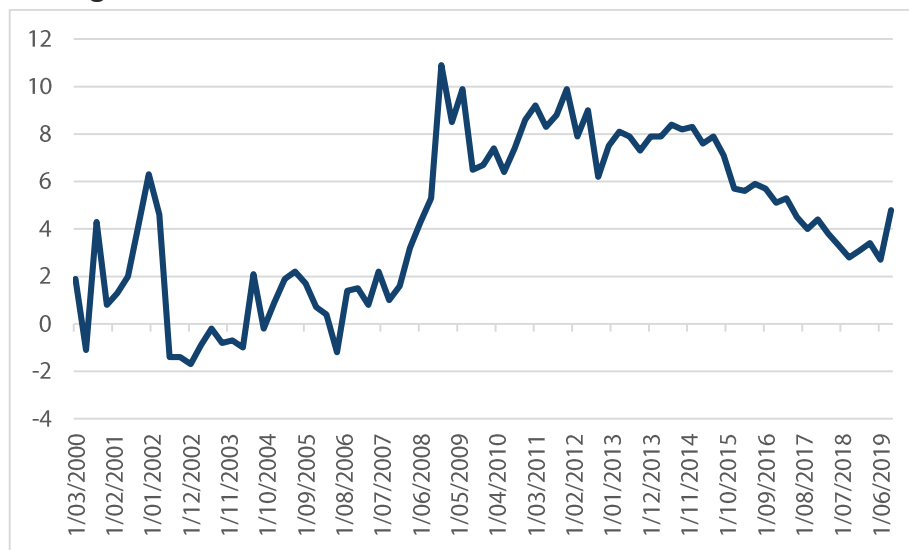
Source: Bloomberg

The Chief Economist of the Australian Bureau of Statistics (ABS) noted that this was due to discretionary spending slowing, causing the savings rate to rise considerably.

"The reduction to tax payable did not translate to a rise in discretionary spending, which led to a visible impact to household saving"

Source: ABS Media Release – Economy Grew 0.4 per cent in September quarter

**Chart 7 Household savings**



Source: Bloomberg

While the wealth effect has obviously not yet flowed through to the economy (savings are rising and consumption is slowing) the lag between house prices and consumption identified above does imply that we should see this begin to improve early next year. If we add on top of this improved disposable income from tax cuts, it is at least foreseeable that households will begin to increase their demand for goods in 2020.

Hence when we look forward for the RBA over the next six months, we can pose some questions to help shape how we think they will behave:

#### Questions to ask

1. Given RBA research and historical comparisons pointing to a 10+% increase in house prices – should the RBA wait to see whether household consumption improves in 2020? Alternatively, should the RBA add additional cuts to push house prices higher and improve their chances of getting households to spend?
2. If the RBA were to cut two more times and start QE in the next six months – how quickly should we expect house prices to rise and what does this mean for financial stability? At what point does housing affordability become an issue again?
3. If consumption doesn't improve with the current interest rate cuts – why should we believe that further cuts would be any different?
4. Are there other external factors that could push them to be more aggressive – such as the trade war continuing to escalate between the US and China.

Our feeling at the moment is that the RBA should be willing to wait and see how the economy evolves from its first round of cuts. While the economic figures so far do not look fantastic, we have only just moved past the worst house price decline since the early '90s, so the consumption outlook should have been weak throughout this year.

Giving the economy some time to react to the support the RBA has provided seems more appropriate than potentially pushing prices up over 20% after repeatedly telling markets that they do not target house prices. Hence we see a growing chance that the market is overpricing the current path of cash rates over the near term.

## Conclusion

Given monetary policy works with a lag we think there is an argument to be made that the RBA should be more willing to wait and watch for improvement in the economic data. While the economic data does not yet look great, the RBA still believes that monetary policy works and that their recent easing will flow through to the economy.

Using 2012/2013 as our yardstick, the RBA should become far more concerned if they do not see any traction in consumption in the early 2020s, as previously households have taken a few quarters to react. Further, if the RBA continues cutting rates and purchasing assets through QE, then we should expect to see house prices continuing to rise at a strong pace.

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